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The slow road to reform

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After a decade or more of liberalisation, democracy and the economy are thriving in some Latin American countries and struggling in others. Why?

A GENERATION ago, the gritty Buenos Aires suburb of La Matanza was a symbol of economic hope. Its car factories, metal-bashing plants and textile mills drew migrants from the interior of Argentina. They represented the dream of national industrial development, nurtured by tariff protection and subsidies.

Nowadays, most of La Matanza’s factories are empty and abandoned. They were unable to compete when Argentina opened its economy to the world a decade ago. Not much, apart from a gleaming new Wal-Mart store, has taken their place. Of La Matanza’s 1.3m people, some 100,000 are unemployed and 36% live in poverty. Hidden behind the main roads lined with cheap shops, the district is studded with shanty towns of flimsy huts of wood and corrugated iron, rutted mud streets and hustling youths.

Argentina’s economy is struggling to pull out of a deep slump. Last month, as investors began to worry that it might be heading for default on its debts, officials began talks with the IMF over an emergency loan.

On the streets, too, frustration is growing. Last week, unions staged a general strike. Earlier in November, unemployed protesters in La Matanza had for a week blocked Ruta 3, the main road south from Buenos Aires to Patagonia. Their leaders denounced “neo-liberalism”. Yet their demands were unrevolutionary. They settled for promises from President Fernando de la Rua’s government of an extra 10,000 places on a workfare scheme (paying $120 a month), food aid and the building of 30 new schools.

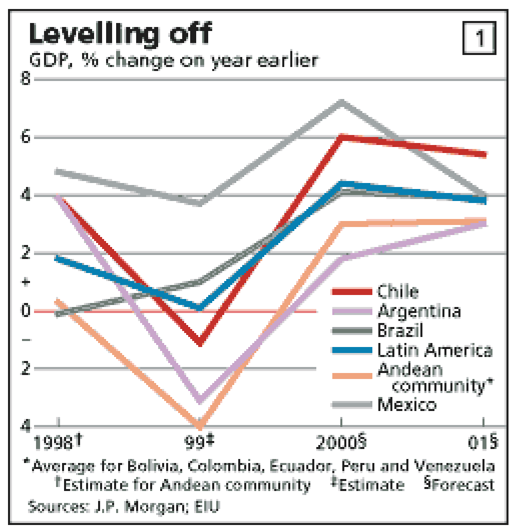
Argentina’s plight is all the more striking, because it had been widely seen as an advertisement for the liberal reforms that swept across the region a decade or so ago. These centred on overcoming inflation through macroeconomic discipline and open trade; openness to foreign investment; more flexible labour markets; large-scale privatisation; and a smaller, more efficient state that would concentrate on delivering better schools and health services.

These reforms were enthusiastically backed by the IMF and the World Bank, but in many countries the push for them came from within. It followed the restoration or renewal of democracy in Latin America during the 1980s, and was a reaction to the failure—expressed in the debt crisis of 1982 and the "lost decade" that followed—of the previous orthodoxy of state-sponsored and protectionist industrialisation, of the kind that gave La Matanza its factories.

Hopes raised and dashed

It was quickly recognised that successful market economies required not just price stability but broad and deep institutional reforms: overhaul of taxes, legal systems and capital markets. Even so, hopes were high that with the cold war over, dictators swept away and seemingly wide support for liberal capitalism, Latin America could achieve both rapid economic growth and stable democracy.

A decade on, the overall results have been disappointing. In the 1990s, the region's economies grew by an average of 3% a year: somewhat faster than the 2% achieved in the previous decade, but more slowly than most Asian economies, including those of South Asia. Factor in the increase in the region's population, and between 1990 and 1999 GDP per head in Latin America expanded by an annual average of 1.1%, according to the World Bank. That was better than in the 1980s, when it fell slightly, but less good than in the 1960s and 1970s, when it increased by 2.5% and 3.5% respectively.



Unsurprisingly, those countries which reformed most, such as Chile, Argentina and Bolivia, have done better than those, such as Venezuela and Ecuador, which did least. And inflation has fallen dramatically: next year, it will be in single digits almost everywhere except Ecuador. But the growth has not been enough to reduce poverty. The World Bank estimates that in 1998 some 36% of the 500m people in Latin America and the Caribbean were poor (meaning that they lived on less than $2 per day), compared with 38% in 1989. Some 16%, down from 18% in 1989, were defined as being in extreme poverty (living on less than $1 per day).

To make matters worse, Latin America has remained prey to boom and bust. The region has suffered two recessions in the past five years. The first was the "tequila" crisis, triggered by Mexico's 1994-95 devaluation, which hit Argentina badly as well. A second recession battered the region in 1998-99, prompted by problems in Asia and Russia and by Brazil's devaluation. Although growth for the region as a whole is likely to be around 4% this year and next, some countries, such as Argentina, will lag.

Political stumbles

Nor has the progress of democracy been uniformly smooth. This year has seen turmoil in the Andean countries in particular. Ecuador's president was ousted in a bloodless military coup in January, although power was handed to his vice-president. Peru faces a difficult political transition after Alberto Fujimori was forced by scandals, including a rigged election, to step down as president last month. In Colombia, peace talks with the left-wing FARC guerrillas, launched by President Andres Pastrana two years ago, have stalled. Violence and kidnapping have sapped economic confidence.

In Venezuela, President Hugo Chavez, a former paratroop officer and failed coup leader, preaches against “rotten” representative democracy, preferring the “participatory” sort. In practice, he is ruling by plebiscite. He has concentrated power in his own hands, while increasing the political role of the armed forces. Elsewhere, democracy has faced various threats in Paraguay, Haiti and Nicaragua; in Cuba, it has yet to arrive.

Even where democracy seems secure, opinion polls regularly show that Latin Americans are dissatisfied with the way it is working and gloomy about the economic future. Mr Chavez apart, this has not (or not so far) translated into a return to power of the populist *caudillos* of the past. But these recent setbacks have prompted much handwringing. Summing up the new mood, Peter Hakim, an experienced observer of the region, asked earlier this year in *Foreign Policy* magazine whether Latin America was “doomed to failure”.

The answer (as Mr Hakim admitted) is no. The setbacks are real enough. But there are some big successes, too. They include Brazil and Mexico, which between them account for half the region’s population and almost 60% of its GDP. Not only is Mexico celebrating a democratic milestone this week with the inauguration of an opposition president, Vicente Fox (see article); but, thanks in part to its links to the booming United States, Mexico’s economy has grown at an annual average rate of 5% since 1996.

Brazil’s devaluation last year, though chaotic, was successful. Having finally vanquished decades of inflation, the economy should be able to grow steadily by at least 4% a year. Faster growth depends on further reform, especially of tax and capital markets, and also on who succeeds President Fernando Henrique Cardoso in 2002. But Brazil’s democracy looks vigorous.

Other, smaller, countries, such as the Dominican Republic and parts of Central America, have also seen growth. And Chile, long the region’s most successful economic reformer, has recovered from recession—though it may find it hard to return to growth rates which averaged 8.3% from 1991-97.

Investment and inequality

Latin American reform has not suffered general failure, nor does it face a regionwide backlash. Far from it. Ecuador’s new government has stabilised the economy by adopting the dollar, and has pushed ahead with reforms. As the price of IMF help, Argentina’s government has agreed with opposition provincial governors on fiscal reforms. El Salvador, too, plans to adopt the dollar—not, as in Ecuador, to stave off hyperinflation, but to cut its borrowing costs.

But some countries have managed to reform more effectively than others; and the reforms themselves have been unable to eliminate some of Latin America’s deep-rooted weaknesses. This is true on both the political and the economic fronts.

First among the traditional economic weaknesses is Latin America’s dependence on foreign capital. This lies at the heart of its vulnerability to outside events. Although the region’s economies were slightly less volatile in the 1990s than in previous years, the instability continues. It contributes to a vicious circle, in which uncertainty discourages long-term planning by business and politicians alike. It is also one reason why Latin America finds it hard to match East Asian growth rates.

Latin America’s bursts of growth in the 1990s coincided with periods of cheap and abundant foreign capital, when investors became besotted with emerging markets Yet those years now look like an exception. Despite generally good economic prospects in Latin America, private capital inflows (net of outflows) to the region are likely to total around $80 billion this year and next, down from $109 billion in 1997, according to the Institute of International Finance, a bankers' association.

Slackening demand for Latin American stocks and bonds this year reflects a broader fear of risk (see chart 2). But it also shows a change of attitude. Lacey Gallagher of CSFB, an investment bank, says that until the Russian default of 1998, investors thought that most Latin American countries would progress smoothly to an "investment" grade (ie, safe) credit rating, a coveted status enjoyed only by Chile, Uruguay and, since last March, Mexico. "Now expectations are more realistic about what these countries' performance will be," she says. As portfolio investment has declined, the share of direct investment in factories and businesses by multinationals has increased. And most of the inflow has gone to Mexico and Brazil.

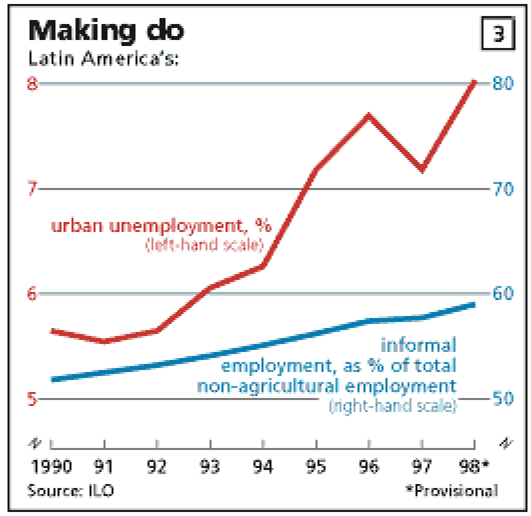
A second traditional weakness has been economic inequality, in which the region, sadly, leads the world. Where growth has been fast, as in Chile and Mexico, poverty has declined, but huge income inequalities persist. Tackling them needs better education systems and, in some countries, land reform. It also probably requires measures to make both taxes and government spending more equitable—without hobbling economic efficiency. "There is not necessarily a trade-off between equity and growth," argues Nancy Birdsall, of the Carnegie Endowment, a Washington think-tank. "If 40% of the population are unable to be productive, that will be a drag on overall growth."

All this leaves governments with work to do. Besides scarcer foreign finance, continued economic volatility, and high levels of poverty and inequality, there are other difficulties. Latin America has a savings rate that is too low, though higher savings are as much a consequence as a cause of growth. Second, Mexico and Chile apart, the region's export performance has been disappointing. Many countries still rely on a handful of commodity exports, whose prices lurch up and down. Improving export performance requires avoiding overvalued exchange rates—one reason why Argentina, with its fixed exchange rate, is in trouble.

What are the policy implications of this? First, fiscal policy needs to be tighter, to boost savings and to allow higher social spending when recession strikes. Although governments are no longer printing funny money (Venezuela, in part, excepted), Chile is the only Latin American country that has managed to conduct a counter-cyclical fiscal policy. The government of Ricardo Lagos, which took office in March, says it plans to run a fiscal surplus averaging 1% of GDP over its term.

Second, banking supervision needs to be stricter, especially in the weaker economies. All the Andean countries saw credit bubbles in the mid-1990s, followed by bank failures of varying severity. In Ecuador, the cost of the collapse of the financial system in 1998-99 may equal 22% of GDP, making it one of the worst banking crises of modern times. While guarding against such risks, capital markets also need to be deepened and corporate governance improved if businesses, especially small and medium ones, are to get the capital they need. And governments need to sweep away the red tape that stifles enterprise.

Lastly, social safety nets need to be improved. Over the past decade, not only has unemployment risen in many Latin American countries, but many of the new jobs have been created in the "informal" sector (see chart 3). When recession and unemployment strike, there is little or no automatic help, as the example of La Matanza shows.



Unemployment-insurance schemes are rare, though Chile now plans to introduce one. "In Europe, the debate is over how to dismantle a rigid welfare state. For us, it's how to have a few rules for more socially just growth," says Mr Lagos.

New economics, same old politics

Many policymakers are well aware of what needs to be done. Whatever their defects, Latin America's economies are in general far better managed than in the past. But implementing reforms, especially those aimed at improving institutions and alleviating poverty, often involves taking on powerful interests. And there's the rub.

A decade ago, the airy assumption of technocratic reformers seemed to be that politics did not matter. In some cases, that was because they worked for strong, authoritarian presidents, such as Mexico's Carlos Salinas or Peru's Alberto Fujimori (as, earlier, market reformers had worked for Chile's Augusto Pinochet). In other cases, it was because they believed that economic reform would automatically lead to political modernisation.

There has been some link between the two. It is hard to imagine that Mr Fox would have won Mexico's presidency without the economic reforms of the past decade. Voters in many countries have favoured politicians who have achieved low inflation. But, in general, governments have found institutional reforms far harder than stabilising prices. Though democratic politicians and economic reformers can agree on the need for more efficient and accountable institutions, in practice change is often resisted.

Latin American traditions of populism, clientelism, corporatism and corruption may ultimately be weakened by economic reform, but they are not immediately eliminated by it. Francisco Panizza, a political scientist at the London School of Economics, argues in an article in the latest issue of the *Journal of Latin American Studies* that the ability of governments to implement reform has had much to do with the success of modernising leaders, such as Mr Cardoso in Brazil and Carlos Menem in Argentina, in recruiting "traditional" politicians to support them.

Those alliances have carried a price. For six years, for example, Mr Cardoso has failed to achieve tax reform. Argentina's difficulties now owe much to Mr Menem's failure to reform public spending. And Mr de la Rua's government could spend more on helping the unemployed of La Matanza if Argentina's party bosses did not stuff public payrolls with their hangers-on.

The vices of traditional politics have done even more to limit reform elsewhere. Mr Chavez's rise in Venezuela, for example, owes much to the corruption of the traditional parties that ruled the country for the previous four decades. One reason for the deep-rooted public mistrust which, until now, has blocked privatisation in Ecuador is that some of privatisation's political backers have a long history of using public policies to promote private interests.

Flawed democracy is still far better than no democracy, for economics as well as human rights. Edmundo Jarquin of the Inter-American Development Bank points out that, by generating political instability, lack of democracy contributed greatly to Latin America's economic volatility in times past—as, this year, it did in Peru.

Even so, the survival of traditional politics and unreformed institutions has led some commentators to return, with a gloomy new insistence, to cultural factors, including Latin America's "Iberian" heritage, to explain reform's difficulties. These may play a role, but they cannot explain why some reform attempts succeed.

Other analysts stress splits within countries between the modern, internationalised, economy and the large and growing informal sector. They think the growth of the informal economy has weakened the state and political parties—fertile ground for *caudillos*, whether of the left, like Mr Chavez, or the right, like Mr Fujimori.

All these analyses recognise that reform does not happen in a vacuum. Certain countries, some in the Andes and Central America, had more vulnerable economies and weaker institutions when reform started. “The conditions one starts from do have a powerful impact on how far you get and how hard it is, and that has been under-recognised,” says David de Ferranti, the World Bank’s top official for Latin America.

In other words, the right policies are not enough on their own. Politics, institutions and ways of behaviour also need to change. And progress is being made, though slowly. If that is not much consolation in places such as La Matanza, it is up to the region’s democratic politicians to put it right.